1965

Cancellation of Salary Indebtedness: Stock Distribution as Realization of Income to Shareholder-Employee

William Tabac
Cleveland State University, w.tabac@csuohio.edu

Original Citation

William Tabac, Cancellation of Salary Indebtedness: Stock Distribution as Realization of Income to Shareholder-Employee, 33 George Washington Law Review 1142 (1965)

> The normal assumption is that the jury will follow the statute, and, acting in accordance with the authority it confers, will accept as sufficient what the statute expressly so describes.[39]

Congress established that the offense of carrying on the business of a distiller without a bond is made out if the prosecution proves that the defendant was in fact present at an illicit still. In view of the fact courts usually defer to legislative policy decisions,[40] which are within constitutional parameters, the Supreme Court in the principal case sustained the statutory presumptions in the Excise Tax Technical Changes Act by upholding the interpretation given by the trial judge in his instructions to the jury. The judge specifically told the jury that the statutory inference was not "conclusive."[41] The jury was to consider "presence" as one circumstance among many, and even if the defendant was found to have been present at the still, and that his presence remained unexplained, the jury could still acquit him if they found that his guilt had not been proved beyond a reasonable doubt.

While the statute in the principal case does not impose a duty upon the jury to convict, it does authorize the jury to convict on the basis of the inferential facts alone. Even a casual trespasser might be convicted of violating the Internal Revenue Code on the basis of his mere presence at the site of an illicit distilling operation. However, the Supreme Court diminished that possibility by adopting the trial judge's interpretation of the statute. Whether in so doing it went far enough in protecting the constitutional rights of the accused remains a valid question.

D. S.

FEDERAL INCOME TAXATION—CANCELLATION OF SALARY INDEBTEDNESS—STOCK DISTRIBUTION AS REALIZATION OF INCOME TO SHAREHOLDER-EMPLOYEE—*C.I.R. v. Fender Sales, Inc.*, 338 F.2d 924 (9th Cir. 1964).

Respondent Fender Sales, Inc., although financially solvent, sought bank financing in 1955. The bank suggested that accrued but unpaid salary obligations owing to respondents Randall and Fender, each 50 per cent stockholder-employees of Fender Sales, be capitalized since these could represent priority claims. In 1956, to comply with the bank's suggestion, Randall and Fender offered to discharge the liability by accepting from the corporation additional stock.[1] The offer was accepted by the corporation's board of directors which consisted of respondents and their wives, and Fender Sales issued 450 shares to each

---

39 Id. at 237.

40 Principal case at 65. See Note, Tot v. United States: Constitutional Restrictions on Statutory Presumptions, 56 Harv. L. Rev. 1324, 1325 (1943).

41 Principal case at 69.

1 The corporation was authorized to issue 2,500 shares of common stock with a par value of $100 per share. In 1953, only 100 shares of this stock were outstanding and respondents each owned fifty. Respondents agreed to accept one share for each $100 of salary debt. Principal case at 925.

of the respondents.[2] In 1958 an additional 150 shares were issued to each respondent for salary indebtedness accrued on the books of the corporation in 1957. In 1956 and 1958 neither Randall nor Fender, cash basis taxpayers,[3] reported any amount as taxable income resulting from the receipt of the shares. The Commissioner determined that the receipt of this stock constituted taxable income in those years. The Tax Court ruled against the Commissioner reasoning that since respondents were the sole shareholders, "their wealth was no more increased by the issuance of additional shares than if the corporation had caused its stock to be split 20 for 1." [4] In the Court of Appeals for the Ninth Circuit, *held*, reversed; discharge by a corporation of its salary obligations by the issuance of additional stock to a stockholder-employee is a realization of income by the employee in the amount of the fair market value of the stock.[5]

To a debtor corporation, cancellation of indebtedness may result in either taxable income or capital contribution. A debt gratuitously forgiven by the creditor results in a contribution to corporate capital.[6] But if cancellation arises from a quid pro quo transaction, the gift rationale fails and taxable income results to the debtor.[7] In the principal case, from the point of view of the corporation's tax liability, the transactions were considered contributions to capital whether viewed as payments for stock or forgiveness of debts.[8]

The individual respondents based their argument against tax liability on the theory that cancellation of the debt was a contribution to the capital of the corporation and not a taxable event since the amount of the contribution is expressly excluded from the corporation's income.[9] They

---

[2] Each respondent was to be compensated at $15,000 per annum. When the 450 shares were issued to each of them, the corporation transferred the total liability amount released to it to capital account. This resulted in a net worth increase of $90,000. Ibid.

[3] Two methods of accounting permissible for income tax purposes are the "cash receipts" method and the "accrual" method. Under the former method, all items constituting gross income are to be included in the taxable year in which actually or constructively received. Treas. Reg. § 1.446-1 (1957), as amended, T.D. 6584, 1962-1 Cum. Bull. 67. Under the accrual method, income is to be included when all events have occurred to fix the right to receive the income and when the amount can be determined with reasonable accuracy. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934); 2 Mertens, The Law of Federal Income Taxation § 12.61 (rev. ed. 1961).

[4] Fender Sales, Inc., 32 P-H Tax Ct. Mem. ¶ 63,119 at 634 (1963).

[5] The court relied on § 61a, Int. Rev. Code of 1954 and Treas. Regs. § 1.61-2 (1957), as amended, T.D. 6416, 1959-2 Cum. Bull. 126 and T.D. 6696, 1963-2 Cum. Bull. 23.

[6] Helvering v. American Dental Co., 318 U.S. 322 (1943); Commissioner v. Auto Strop Safety Razor Co., 74 F.2d 266 (2d Cir. 1934).

[7] Helvering v. Jane Holding Corp., 109 F.2d 933 (8th Cir. 1940). But see Carroll-McCreary Co., Inc. v. Commissioner, 124 F.2d 303 (2d Cir. 1941).

[8] "Gratuitous" forgiveness is interpreted to mean that no consideration was paid *by* the corporation for release of the debt. Helvering v. Jane Holding Corp., supra note 7. In so far as this is an objective test, it is immaterial that the taxpayer was motivated by "business reasons." Helvering v. American Dental Co., supra note 6. Contra, Capital Coal Corp. v. Commissioner, 250 F.2d 361 (2d Cir. 1957).

[9] Int. Rev. Code of 1954, § 1032a. The court noted that the individual respondents'

also contended that the transaction was equivalent to a distribution of a stock dividend so that, on the basis of *Eisner v. Macomber*,[10] they received nothing which they did not already possess, *i.e.*, the entire capital stock of the corporation. They argued that two non-taxable events in combination cannot generate liability.

Judge Thompson, writing for the majority, found the language of *Helvering v. Horst*[11] applicable to respondents' first contention:

> [I]n Horst, the Supreme Court relied on the broader concept of the "realization of income" rather than a restricted notion of actual payment for its conclusions and we think it necessary and logical, in the just administration of the tax laws, that the courts continue to recognize that a taxpayer may realize the income represented by an account receivable by exercising his rights of control and disposition over it for his economic benefit in ways other than receipt of payment in money. . . . [T]he exercise of the power to dispose of income is the equivalent of ownership of it.[12]

The same argument had been made before the Tax Court by the Commissioner of Internal Revenue in 1943. In *John Harvey Kellogg*,[13] petitioner, an officer and board member of a charitable non-stock corporation, waived his rights to salary which had accrued over the years on the corporation's books. The Commissioner argued that his gratuitous forgiveness of the indebtedness was a gift; that a gift presupposes something to give (the past due salary here); and that one having the right to income may realize it through the enjoyment of transferring it, as in *Horst*. Therefore, argued the Commissioner, the waiver of salary consti-

liability is not dependent on whether the corporation is liable. Principal case at 928; Burnet v. Clark, 287 U.S. 410 (1932) (corporation not an alter-ego or agent).

10 252 U.S. 189 (1919).

11 311 U.S. 112 (1940). *Horst* concerned a taxpayer who clipped coupons from a coupon bond and transferred them to the donee who held them when they were paid at maturity. The issue was "who" was to be taxed—donor or donee. The Court held that the donor had realized income since, as owner of the bonds, he possessed a legal right to demand payment at maturity and had the power to command payment to others. "[S]uch use or disposition of . . . power to receive or control the income . . . [is] to procure . . . other satisfactions which are of economic worth." Id. at 116. "The dominant purpose of the revenue laws is the taxation of income to those who earn . . . the right to receive it . . . and enjoy the benefit of it when paid." Id. at 119. Accord, Helvering v. Eubank, 311 U.S. 122 (1940). The courts have emphasized the control wielded by the taxpayer: "[T]axation is . . . concerned with the actual command over the property. . . ." Anthony's Estate v. Commissioner, 155 F.2d 980, 981-82 (10th Cir. 1956) (transfer of oil leases and accrued income); "[T]he exercise of the power of disposition of the . . . compensation with the resultant payment to the donee . . . is the enjoyment." Id. at 982; see also Johnson v. United States, 135 F.2d 125 (9th Cir. 1943) (power to dispose equivalent to ownership). But see Commissioner v. Giannini, 129 F.2d 638 (9th Cir. 1942), where a waiver of the right to future compensation by a corporation president did not result in a realization of the income to him when donated by the corporation to charity. "So far as the taxpayer was concerned, the corporation could have kept the money. All arrangements . . . regarding the donation were made by the corporation." Id. at 641.

12 Principal case at 929.

13 2 T.C. 1126 (1943).

tuted a constructive receipt and simultaneous surrender. The court rejected this argument stating that:

> [W]hen we come to apply the Commissioner's conception to the numerous easily imagined situations in which actual receipt . . . would be constructed out of conduct amounting to realization because of satisfactions and enjoyments, there is a prohibitive difficulty in keeping the realization within rational limits.[14]

The Commissioner acquiesced in the court's decision.[15]

In factual situations not involving cancellation of salary indebtedness, however, the courts have been less reluctant to find realization when "satisfactions and enjoyments" accrue to taxpayers. Thus, where taxpayer borrowed money from a corporation, of which he was president, which issued monthly salary credits to the full extent of his salary and then applied them in satisfaction of the loan, the court determined that the taxpayer had received income when his salary was credited against the debt.[16] And where a widow elected not to claim interest due her on notes given by her husband during his lifetime, the court determined that she had used her power to relinquish income due her from the estate to procure "other satisfactions of economic worth," namely a gain in assets of a testamentary trust.[17] In the principal case, the court reasoned that since the debtor corporation received a contribution to capital, respondents must have made the contribution. This brought economic satisfactions amounting to realization.[18]

The court's answer to respondents' second argument was that the common-stock divided transaction involved in *Eisner v. Macomber*[19] was distinguishable from the two-party transaction in the principal case. The voluntary, contemporaneous, quid pro quo transactions which resulted in an increase in the corporate net worth, were distinguished from a stock dividend.[20] The latter is not the result of a bargainable transac-

---

[14] Id. at 1127.

[15] Rev. Rul. 24-11907, 1944 Cum. Bull. 16.

[16] Newmark v. Commissioner, 311 F.2d 913 (2d Cir. 1962).

[17] Potter v. Fahs, 71 F. Supp. 675, 677 (S.D. Fla. 1947).

[18] See Lidgerwood Mfg. Co. v. Commissioner, 229 F.2d 241 (2d Cir. 1956) (enabled controlled subsidiaries to obtain bank loans).

[19] Supra note 10. In Benjamin Josephson, 16 P-H Tax Ct. Mem. ¶ 47, 186 (1947), petitioner-president and sole stockholder forgave a salary liability which the corporation had accrued on its books. The corporation, which had an authorized capital stock of $5,000 represented by fifty shares (held by petitioner) with a par value of $100, increased its capital stock from fifty to five-hundred shares in the same year that he forgave the debt. The Commissioner argued that the "stock dividend" was in payment of salary. The court determined otherwise since (1) as the sole shareholder petitioner's wealth was not increased by the additional shares and (2) the issuance of such shares was not income whether a stock dividend or salary. Id. at 680. Deloss E. Daggitt, 23 T.C. 31 (1954), also relied upon by respondents, concerned a corporation president who included the amount accrued on the corporate books in 1947 as income payable to him in his personal income tax return. He received the stock in 1948. The Commissioner argued that the receipt of the stock was the taxable event. The court held for the petitioner.

[20] Principal case at 927.

tion; surplus accrues through contributions, earnings, and profits and the stock issued to the shareholders, without their exercise of will, represents an increase in net worth already accomplished.[21] A common stock dividend is pure paper work—a transfer on the corporate books of surplus to capital—which does not affect the corporation's net assets or outstanding liabilities and the receipt of which cannot be income within the meaning of the sixteenth amendment.[22] Not only does the holder of a stock dividend receive nothing out of the corporation's assets for his separate use and benefit, but also:

> every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money. . . still remains the property of the company, and subject to business risks which may result in wiping out the entire investment.[23]

As the concept of income became broader,[24] the severance requirement of *Eisner* was eliminated. In *Helvering v. Bruun*,[25] involving not shares of stock but improvements on real property, the Supreme Court said: "It is not necessary to the recognition of taxable gain that. . . [the taxpayer] should be able to sever the improvement begetting the gain from his original capital." [26]

Congress immunized the stock dividend from taxation in 1954, but the courts already had distinguished between the *Eisner* situation, in which the proportional interest of the shareholder remained unchanged after receipt of the stock dividend, and situations where the proportional

---

21 Burtchett, Corporation Finance (1934) states:

> When a corporation declares a stock dividend, it merely transfers from the surplus to the capital stock account. In theory, what happens is that the corporation declares a cash dividend payable from the cash which is to be received from the sale of stock to the old stockholders for cash. Hence the corporation sells stock for cash to the old stockholders, then dispenses the cash to the purchasers of the stock. By a cancellation of the cash transactions, the stock was sold to the old shareholders for a portion of the surplus.

(Involuntary as to the shareholder.) Id. at 641.

22 Income was defined as:

> [N]ot a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however vested or employed, and *coming in*, being "*derived*," that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; — *that* is income derived from property. Nothing else answers the description.

Supra note 10, at 207. (Original emphasis). In Towne v. Eisner, 245 U.S. 418 (1918), Justice Holmes, who dissented in *Macomber*, said: "A word . . . [income] is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." Id. at 425.

23 Supra note 10, at 211.

24 See, e.g., Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

25 309 U.S. 461 (1940).

26 Id. at 469. The *Bruun* case has been called a complete denial of *Eisner*. Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 Ill. L. Rev. 779 (1941).

interest of the stockholder was changed after the distribution.[27] If the new and old shares together gave the stockholder a proportionally different interest in the *corporate assets*, income had accrued to the shareholder in the amount of the dividend.[28] Taxpayer's gaining dominion and control over the dividend shares was the taxable event.[29]

Circuit Judge Barnes, dissenting in part in the principal case, disagreed with the majority's extension of the "dominion and control" cases to the respondents' transactions. He stated that the nature of corporate net worth, its viability, should be left on paper by a rule that the transactions had changed only shareholder equity. The increase in net worth of the shares should not be taxable "until such time as the shareholders realize the increase by virtue of a dividend, or the sale or exchange of the security investment above cost." [30]

Judge Barnes also considered another approach. Since the two equal owners of the corporation were cash basis taxpayers who had worked for the corporation for three years without salary, neither had current employment income subject to tax although the full-time services each rendered were, by agreement, equivalent to $15,000 per year. At the end of three years, presumably, these services had increased the corporate net worth by $90,000. Therefore, respondents had chosen not to take current salaries and be taxed at ordinary income rates but rather to increase the value of their investment, to be taxed at a subsequent time at capital gain rates.[31]

This capital gain approach seems to overlook the status enjoyed by respondents up to the point of the transfers in question. The accrued salary obligations were in no way "invested" in the corporation in the form of capital. They represented liabilities on the corporate books which had been deducted as operating expenses in the years in question. Respondents had enjoyed the status of creditors,[32] with cor-

---

27 Koshland v. Helvering, 298 U.S. 441 (1936).

28 Id. at 442. A proportional increase in stockholder interests presupposes two or more stockholders. After the stock distribution they stand in different positions with respect to each other and to the corporation. Such an increase would occur, for example, in the case of a corporation with a net worth of $10,000 and having both common and preferred shareholders. If the preferred shareholders hold shares with a book value of $1,000 and a preferred stock dividend of $1,000 is issued to the common stockholder, the latter's proportionate interest has increased. See Surrey and Warren, Federal Income Taxation 1308 (6th ed. 1962). The "proportionate interest" test was adhered to but dividends of stock were not spoken of in constitutional terms. Helvering v. Griffiths, 318 U.S. 371 (1943); Helvering v. Sprouse, 318 U.S. 604 (1943); John A. Messr, 20 T.C. 264 (1955) (seven per cent increase in proportionate interest held taxable). For a history of the tax treatment of stock dividends, see generally, Lowndes, The Taxation of Stock Dividends and Stock Rights, 96 U. Pa. L. Rev. 147 (1947).

29 See United States v. Phellis, 257 U.S. 156, 170 (1921).

30 Principal case at 930.

31 Id. at 931.

32 Joy Mfg. Co. v. Commissioner, 230 F.2d 740 (3d Cir. 1956) (dissenting opinion).

> [T]axpayer was a creditor . . . having rendered services to which it was entitled to compensation; [the corporation subsidiary] . . . recognized the relationship by entering on its books as an account "payable" to taxpayer, the

responding rights in the event of dissolution.[33] The salary obligations thus were not "business risks which may wipe out the entire investment", nor were they "investments" entitled to capital gains treatment until they were cancelled.[34]

Upon the execution of the agreement between the corporation and respondents, the latter received stock with a fair market value corresponding exactly to the increase in net worth and to the salary owing to them. A finding of realization and the levying of a tax in such circumstances was not equivalent to "recognizing a realization of income by shareholders upon an increase in corporate net worth." [35] The transaction in issue was controlled and valued by the parties to it and, in effect, sealed by the receipt of the stock.[36] It was convenient to find realization and tax liability at this point.[37]

By taxing at ordinary rates the benefit realized by respondents when they invested the income in the corporation which they owned in exchange for its stock, the court eliminated the possibility—suggested by the dissent—of any undeserved capital gains treatment.[38] The case serves to reinforce the *fait accompli* in the tax law[39] between the treatment of ordinary income and capital transactions.

W. T.

> . . . fees as they were earned. As a creditor, taxpayer had a right to enforce its claim.

Id. at 748. The holding in *Joy* conflicts with the principal case. See Newmark v. Commissioner, supra note 16.

[33] See Bankruptcy Act § 55, 52 Stat. 865 (1938) as amended, 11 U.S.C. § 91 (1964); Cal. Corp. Code § 5000.

[34] Eisner v. Macomber, supra note 10.

[35] Principal case at 930 (dissenting opinion).

[36] "Fortunately, under the agreed facts of this case we have no problem respecting the taxable value of the income thus realized. . . ." Id. at 929.

[37] Helvering v. Horst, supra note 11, at 116 (administrative convenience). That "realization" is merely an administrative device suited to convenience rather than "principle," see Lowndes, supra note 28 (income realized because taxed; not taxed because realized).

[38] In 1954, Congress also plugged the loophole known as the "preferred stock bail-out" with section 306. The loophole brought capital gains treatment to what was essentially a corporate distribution of surplus through a preferred stock dividend. If, for example, a shareholder owning all of the stock of a corporation in the form of common stock was issued a preferred stock dividend, his proportionate interest in the corporation would remain as it was before the distribution and he would not be taxed upon the receipt of the additional shares. Helvering v. Sprouse, supra note 28. A stock dividend does not result in an increase in corporate net worth. The transaction is normally a book transaction wherein the surplus account is debited and capital account (that used in the business) is credited. The par value of the stock dividend is equivalent to the amount transferred. If the surplus had been distributed in the form of a cash dividend, it would have been taxed at ordinary income rates. Int. Rev. Code of 1954, § 301. If the shareholder sold the preferred stock received as a dividend, the money or property received in exchange was taxed at the capital gains rates. Chamberlain v. Commissioner, 207 F.2d 462 (6th Cir. 1953). By selling only the preferred stock the shareholder still retained all of his corporate ownership. Section 306, however, does not apply to common stock. Sale of dividend common stock received by the respondents in the principal case would result in a diminution of their control.

[39] See 2B Mertens, The Law of Federal Income Taxation § 22.01 (rev. ed. 1961). "[T]he prominent fact remains that a distinction has been made . . . and that . . . [capital gains] has been given markedly favored tax treatment." Id. at 8. See Lazarus v. United States, 172 F. Supp. 421 (Ct. Cl. 1959).